Mercer

After the climb comes the descent

Economic and Market Outlook 2025

welcome to brighter

After the climb comes the descent

Executive summary

By Rupert Watson, Global Head of Economics and Dynamic Asset Allocation, Mercer

France's Alpe d'Huez is renowned as one of the most challenging climbs in cycling. But reaching the peak is only half the battle as the descent awaiting cyclists presents a winding and technically challenging route down the mountain. Similarly, after a period of aggressive interest rate hikes in 2022 and 2023, central banks face a difficult challenge in the descent from peak rates.

With the risks between growth and inflation now more delicately balanced, the Federal Reserve (the Fed) and other central banks are cutting interest rates to loosen monetary policy from current restrictive levels back to more neutral ground. Central banks are likely to keep cutting interest rates at various intervals until the road looks a lot smoother — hoping the economy doesn't get a flat tire on the way.

Despite the rate cuts, we expect growth in the developed world to soften in the near term due to the lagged impact of restrictive monetary policy. However, recession risks are low thanks to the strength of corporate and household sector balance sheets. Japan should grow at a decent pace, driven by domestic demand and higher income growth. Meanwhile, the eurozone faces limited near-term growth catalysts. Looking further out into 2025, we expect the loosening of monetary policy to boost growth. There are now, however, risks to this base case to both the upside and downside in the US following the election of President-elect Trump. China's growth outlook is uncertain, although the recent stimulus announcements from the People's Bank of China and financial regulators highlight their intent to put a floor under growth. Nevertheless, with ongoing weakness in China's property sector and weak consumer confidence, further steps that stabilize property prices and/or directly encourage consumers to get their wallets out may be needed. Elsewhere in emerging markets (EM), growth should remain robust, benefiting from more accommodative monetary policy and pro-cyclical conditions. The risk of 60% tariffs on China would be negative for Chinese growth but positive for EM ex-China as trade is redirected.

Inflation has declined, and, in 2025, we believe it will walk the final mile to bring it to target levels. Labor markets in developed market (DM) economies, including the US, have loosened, driven by decreased labor demand and increased labor supply. Wage growth remains somewhat elevated but is expected to normalize, contributing to lower inflation. However, higher tariffs in the US following Donald Trump's election create upside risks to inflation. In Japan, where the challenge has been deflation, inflation is also likely to be near 2%, driven by wage growth, which increased sharply this year with the highest negotiated pay rise in over 30 years. We think that creates modest upside inflation risks versus the Bank of Japan's (BoJ) 2% target. China is facing deflationary pressures, similar to Japan in the late 1990s. Core inflation is trending downwards, and deflation could become self-fulfilling if inflation expectations become anchored below 0%. The recent loosening of monetary and fiscal policy will help in its fight against deflation, but victory is not yet assured.

Policy backdrop

Central banks in developed countries are cutting interest rates as inflation has fallen. The journey back to neutral rates has begun, with bond markets pricing a rate-cutting cycle. By the end of 2025, DM central banks (excluding Japan) are expected to cut rates back to neutral levels, which, while highly uncertain, are perhaps near 3.5% in the US, 3% in the UK and 2% in the eurozone. After reaching these levels, they may pause or slow their cutting cycles to assess the impact of the cuts, mindful that monetary policy operates with a lag. In China, substantial demand-side stimulus measures are needed to address weak growth and deflation risks. Recent moves suggest a step in that direction, but whether growth will meaningfully increase remains uncertain. Outside China, EM central banks are largely expected to continue cutting rates. Localized rate hikes in select EM countries may occur due to domestic factors, but it is not expected to be a broad trend. The BoJ is expected to continue hiking interest rates gradually, with inflation remaining above its target, reaching the lower bound of their neutral rate estimates (~1%[1]) by 2025. The pace of hikes may increase if inflation, wage growth and economic growth remain firm.

Equities

In 2025, we expect a mixed backdrop for equities, with a supportive economic environment and potential upside from AI supporting earnings. Although partially offset by stretched valuations, equities could still offer higher expected returns compared to cash and may warrant an overweight position. We think opportunities can also be found in Japanese equities and REITs.

Fixed income

In credit markets, we like Asia high yield (AHY) on valuation grounds and a supportive macroeconomic backdrop. Frontier market debt (FMD) offers solid fundamentals, attractive yields and a well-diversified universe. While global high yield may generate a reasonable return, we are underweight given very tight spreads and as a partial offset to the AHY and FMD positions. Government bond markets, especially the US, have cooled their expectations for aggressive interest rate cuts, and we still believe central banks may take a gradual approach. We are modestly underweight duration as we believe this will help manage the risk that a big increase in yields weighs on other positions in the portfolios, while some of President-elect Trump's policies could put upward pressure on yields.

FX

We maintain an overweight position in the Japanese yen versus other DM currencies as the headwind from the high-interest-rate differential falls while the US and others cut interest rates and Japan raises them more than markets are pricing. The yen remains exceptionally cheap, and our long yen position is funded by non-US currencies, with the US dollar likely supported by the threat of tariffs from the new Trump administration.

Growth

Growth in much of the developed world is likely to soften in the near term as the lagged impact of tighter monetary policy weighs on economic activity. However, we do not believe the risk of a recession is high. Instead, we expect DM economies to grow modestly below trend at the end of 2024 and into 2025, although US economic activity remains decent. Strong household and corporate sector balance sheets and easier financial conditions should partially offset the lagged negative impacts from past interest rate hikes, while the current interest rate loosening should lay the foundations for a stronger second half of 2025. Following the US election, the outlook for growth in 2025 is now somewhat more complicated but really impacts our views as risks to our base case rather than any sort of fundamental change. Upside risks to growth emerge from looser regulation and looser fiscal policy. However, downside risks to growth are likely to come from tariffs, which are negative to growth and disruptive for business.[2]

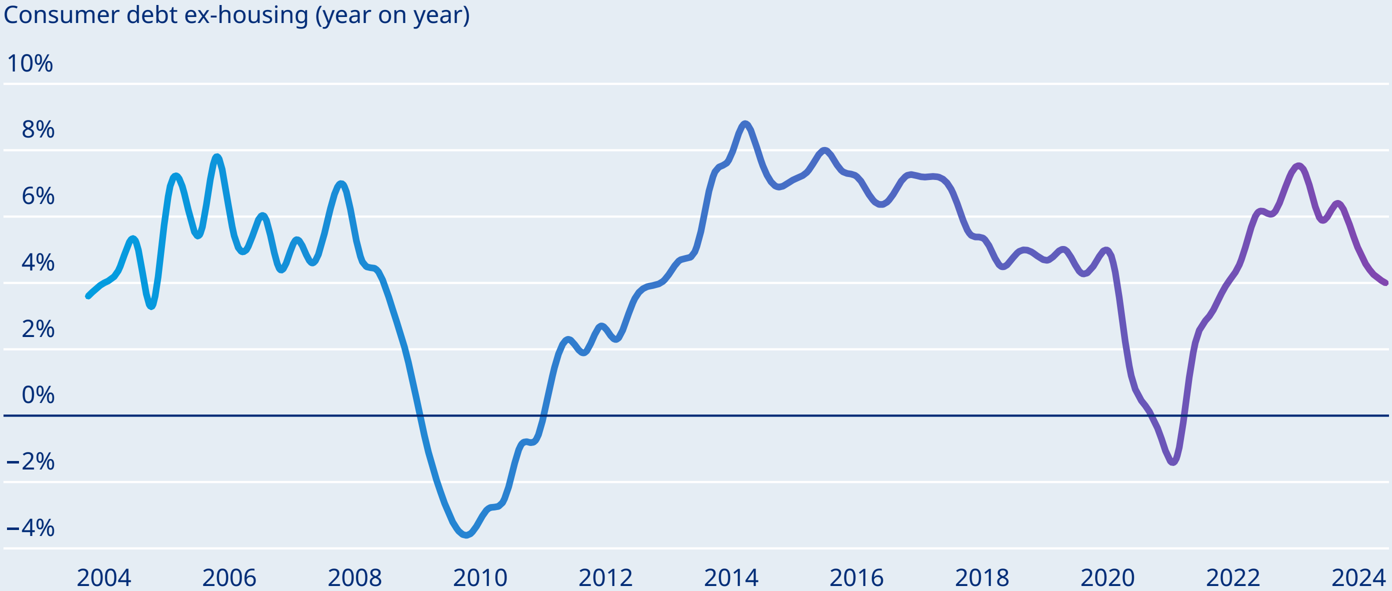
Japan is likely to do well. The country has entered a fundamentally different regime than where it spent most of the past 30 years, meaning we should see nominal GDP growth of around 3% on average compared to around 0.5% before. Real wage growth has turned positive, which should support higher levels of consumption.

Although the BoJ is beginning to gradually tighten monetary policy, interest rates will remain low for the bulk of 2025, which should continue to support economic growth. Finally, several major automobile factories shutting down in 2024 weighed on production and shipments, lowering durable goods consumption and exports. As this shutdown reverses and works its way out of the GDP numbers, growth should see a rebound.

We see few catalysts in the eurozone for a near-term pickup in growth. However, savings rates are elevated; as inflation moderates and the European Central Bank (ECB) cuts rates, consumers may once again start spending.

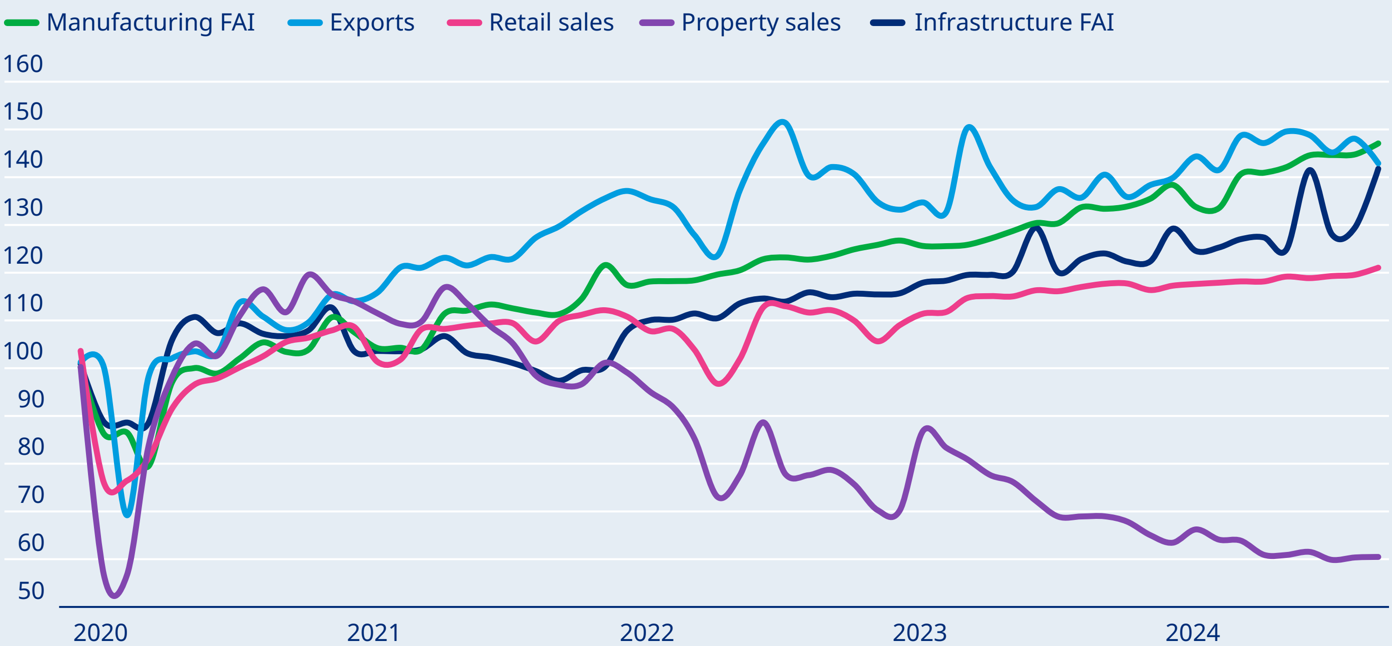
As we look further into 2025, the loosening of monetary policy is likely to boost growth. This effect may be more pronounced outside the US, particularly in the eurozone, the UK and Australia, where the transmission of monetary policy should be quicker due to a higher share of floating rate mortgages. In the US, the housing sector has struggled in recent years due to higher interest rates, which have constrained both supply and demand. Lower interest rates should stimulate activity in the sector. This is partly due to lower rates making financing cheaper for developers, enabling them to increase the housing supply. It will also boost demand from new buyers entering the market.

Figure 1. US households and businesses remain in good shape



Source: Bloomberg, Federal Reserve of New York, Mercer. Data as of June 30, 2024.
Consumer debt ex-housing includes auto loans, credit card debt, student loans and other debt.

Figure 2. Exports have offset a weak property sector in China



Source: Gavekal, Macrobond, CEIC, Mercer. December 31, 2019 = 100. Data as of September 30, 2024.

China's growth outlook remains uncertain. On the one hand, China is the world's leading producer of new-economy technologies such as electric vehicles and solar panels and is focused on higher-end manufacturing, industrial production and exports. On the other hand, China is continuing to face weak consumer confidence and spending driven by the ongoing issues in its property sector and weakness in its labor market. China's policymakers have made it clear they are committed to meeting their annual growth target. Although actions prior to September were insufficient and too focused on boosting the supply side of the economy, more recent announcements and policymaker rhetoric indicate their seriousness in trying to boost growth and resolve various challenges. This should reduce the economy's reliance on exports as a source of growth. For China to mount a sustainable recovery, we think stimulus should be aimed at boosting consumer confidence and stabilizing its struggling property sector. Importantly, it is possible that tariffs announced by President-elect Trump could only be for posturing to negotiate a deal between the US and China. If, however, they were implemented, they would unambiguously be negative for Chinese exports and thus real GDP. This would put further pressure on Chinese policymakers to loosen policy to put a floor under growth and likely weaken its currency.

Although our outlook on China has a wider distribution of outcomes and is more conditional on stimulus measures, our outlook on EM excluding China is more positive. Broadly speaking, further loosening of monetary policy domestically and by developed central banks combined with supportive macroeconomic conditions (stable inflation and increasing consumer confidence) are supportive of EM economic growth. On the other hand, President-elect Trump's commitments to increase tariffs across the board should lead to a stronger US dollar, which is typically a headwind for many EM economies.

Nevertheless, Asian economies, especially those higher up the value chain — Taiwan and Korea — should continue to see expansion in industrial production as demand for exports remains strong, especially in critical areas such as semiconductors and high-end electronics. India has solid economic momentum and is set to continue to attract capital over the coming years, if not decades.

Latin American (Latam) economies are more exposed to softer growth in developed countries and uncertainties in China given its higher reliance on cyclical sectors like commodities and manufacturing. Also, many Latam countries are set to hold elections in 2025, which may also bring uncertainties. That said, key metal producers in this region, such as Brazil and Chile, should continue enjoying the tailwind from the energy transition as metals like copper and lithium play critical roles in enabling electric vehicles and solar technology.

Finally, as a general theme, EM ex-China should broadly benefit from US companies shifting manufacturing capacity away from China, especially in a world where the US is implementing tariffs of up to 60% on China, providing a further tailwind to growth.

Inflation

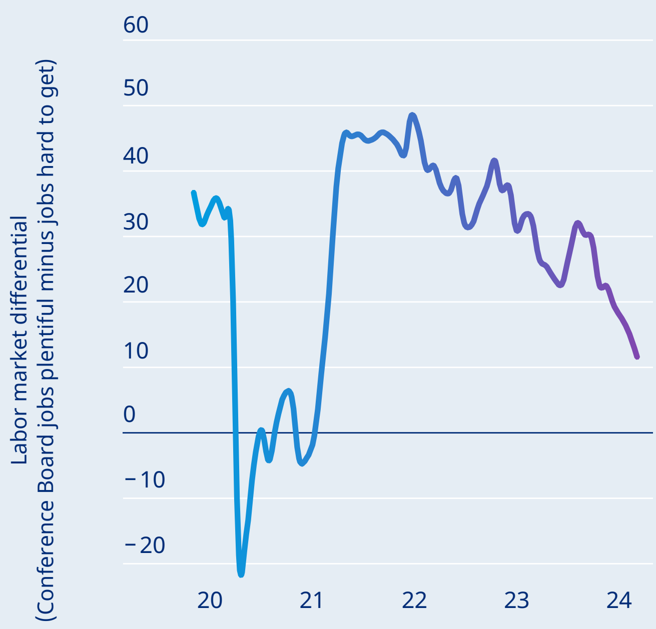
Inflation started 2024 on a bad note, with numerous upside surprises, especially in the US. However, these upsides faded as the year progressed. We expect inflation to continue normalizing in 2025 for a number of reasons.

- First, and most important, labor markets have loosened as shown by the unemployment rate rising and job openings falling. Although wage growth is currently too high, we expect cooling labor markets to mean slower wage growth, further lowering service price inflation.
- Second, we expect shelter inflation in the US to fall further, reflecting the weakness seen in private-sector data on new rents.
- Third, and finally, in developed markets, some prices rose sharply at the start of 2024 in response to the high headline inflation in 2023. With headline inflation much lower in 2024, similar upward surprises should be lower in 2025.

The wrench in all this for US inflation is increased tariffs and an increased fiscal deficit. It remains to be seen whether these tariffs are actually implemented and in what size or whether they are just a negotiation tool. Notwithstanding this fact, higher tariffs and wider deficits are inflationary in the year the changes are designed but not necessarily thereafter. Therefore, as long as inflation expectations remain anchored, inflation should fall back to target.

We think the inflation pickup seen in Japan is not just a head fake. Current conditions in Japan feel a far cry from the days when average inflation was close to 0%. Year-on-year core CPI[3] averaged 2.5% over the year to September 2024. More important, inflation has largely

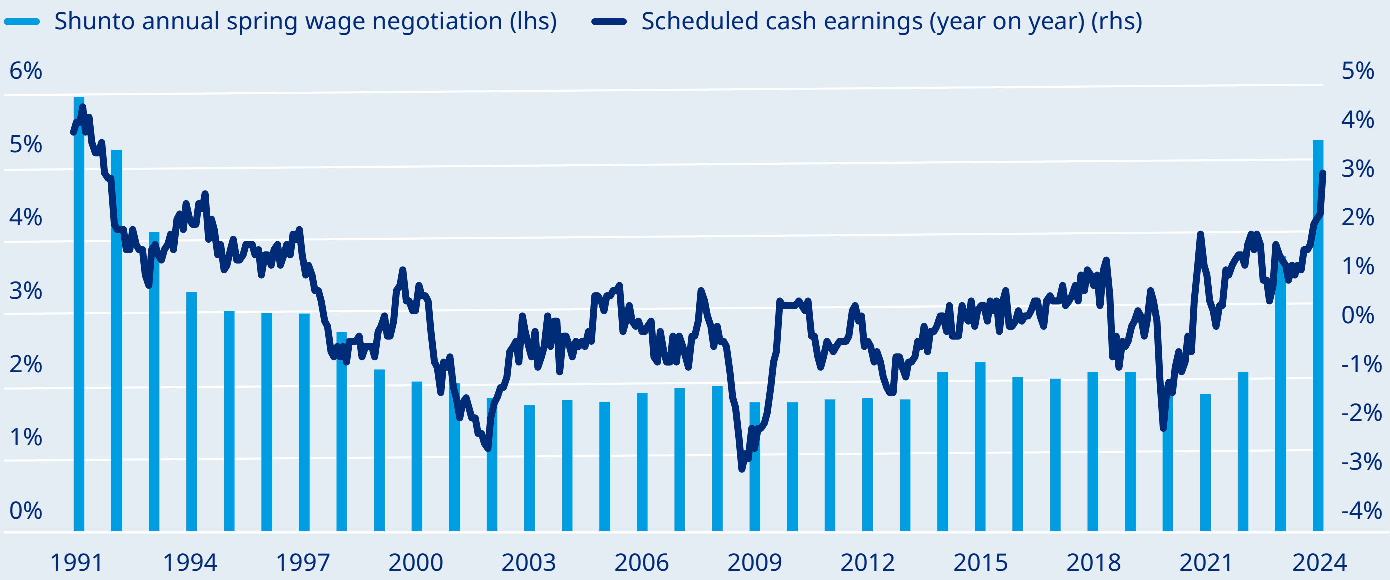
Figure 3. US labor markets have loosened



Source: Conference Board, Refinitiv, Mercer.
Data as of September 30, 2024.

been driven by more sustained underlying price pressures, such as wage growth, as opposed to one-offs or external shocks. Our attention in 2025 will once again shift to the Shunto spring wage negotiations. In 2024, these negotiations proved consequential, with the highest wage boosts in 30 years. For inflation expectations to settle at higher levels and for the wheel of inflation[4] to spin, wage growth must continue to rise at these elevated rates.[5] Labor unions' opening demands for 2025 wage hikes suggest a high probability of this occurring. We expect decent nominal growth, structurally tight labor markets and changing consumer attitudes toward inflation to keep wage growth high into 2025.

Figure 4. Strong Shunto results have fed through into actual cash earnings



Source: Bloomberg, Mercer. Data as of August 2024.

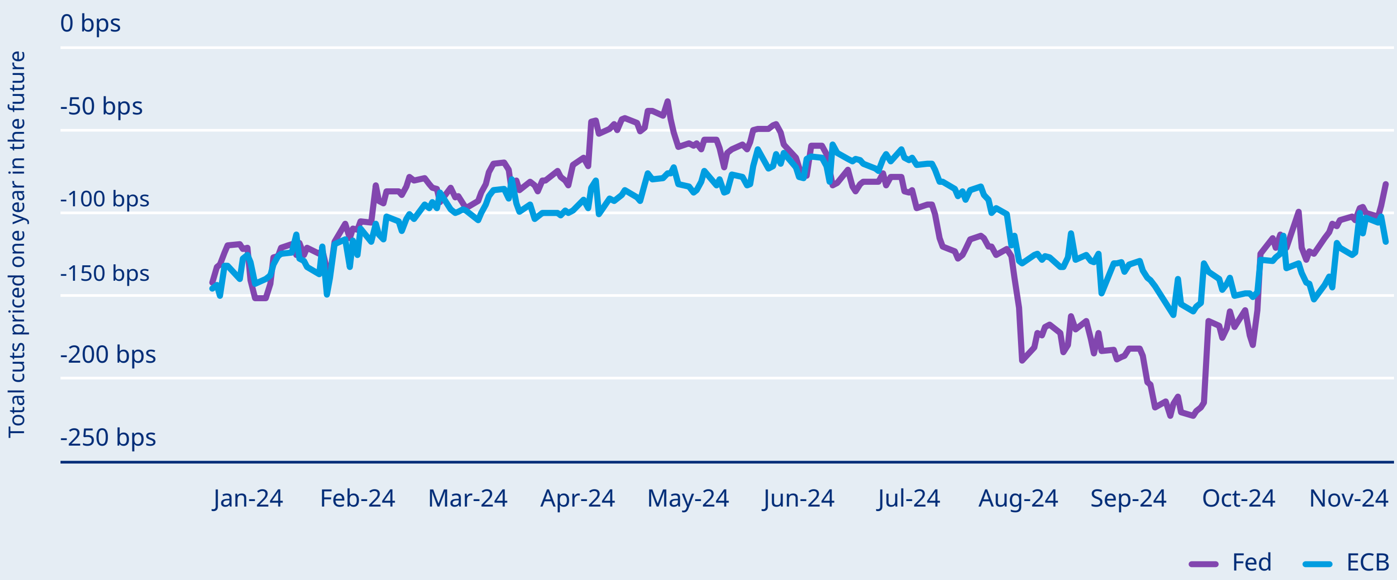
China is facing different pressures from much of the world. Its challenges resemble the problems Japan faced in the late 1990s, with China on the brink of deflation. Core inflation has been trending downward for several quarters and is getting dangerously close to zero. There is now the risk of a self-reinforcing spiral of persistent very low inflation or elevated deflation given the issues in the property sector, chronically high savings levels, low consumption and high levels of debt-to-GDP among many local governments. However, what China has that Japan did not have in the 1990s is a playbook for what to do. If China can learn anything from the deflationary episode in Japan, it is that policymakers should not wait too long to act. Whether China moves quickly remains uncertain, although recent policy loosening is a step in the right direction.

Inflation across EM (ex China) economies has come down significantly in the past two years. Broadly, we expect inflation to normalize in 2025 due to the lagged impact of tight monetary policies and lower inflation in China, which reduces import prices in EMs and elsewhere.

Central bank policy

With inflation risks receding in much of the developed world, central banks are cutting interest rates as the journey back to neutral[6] begins. Bond markets had been pricing in an aggressive rate-cutting cycle, although expectations have cooled, particularly in the US. We suspect policymakers may pursue a more gradual easing of policy, especially as 2025 progresses. We expect DM central banks (excluding Japan) to cut interest rates back to neutral levels by the end of 2025. However, a scenario is possible where the Fed and other central banks push interest rates below neutral if economies are weaker than we expect. We think this scenario is more likely to occur in the eurozone, New Zealand and Switzerland, where growth is soft. The Fed could have a more challenging job as it will want to avoid preempting policies that may not actually materialize, such as tariffs. Nonetheless, a rise in inflationary pressures could lead to a higher path of interest rates in 2025 and beyond.

Figure 5. Bond markets are pricing cuts over the coming year

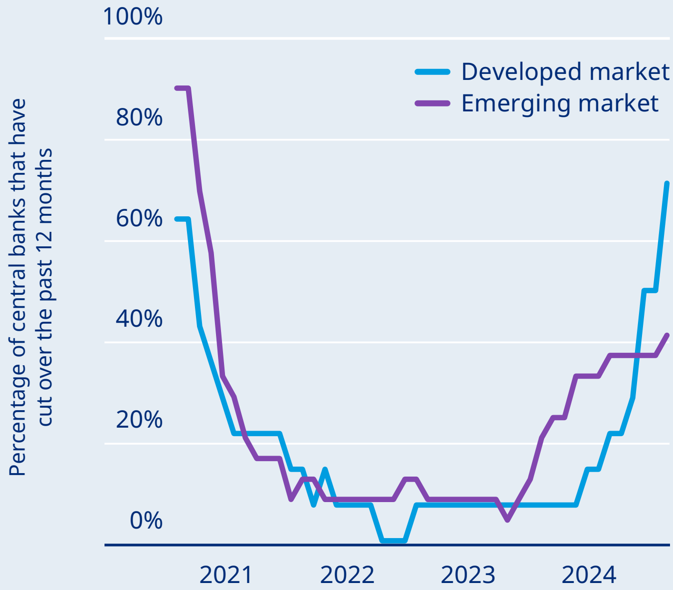


Source: Bloomberg, Barclays, Mercer. Data as of November 6, 2024.

Faced with a risk of deflation and slow growth, we think China's policymakers need to enact further fiscal policy stimulus measures, especially if the threat or actuality of major tariffs materializes. However, it is likely that monetary policy is approaching its limits. Stimulus measures could include boosting property demand to reduce China's excess inventory problem. Stimulus measures implemented to date targeting the property sector have lacked effectiveness and momentum or were generally inflexible, limiting their impact. Further, more powerful measures are needed to definitively resolve the property crisis, revive consumer confidence and lead to stronger consumption.

EM (ex-China) central banks are likely to continue cutting interest rates in 2025, having briefly paused rate cuts in the second half of 2024 due to concerns over devaluing their currencies too much compared to the US dollar. Developed economies cutting rates should alleviate FX pressures over EM economies and allow central banks to normalize policy further. Of course, not all countries are the same, and some may need to raise interest rates due to local factors; however, we do not expect that to broaden out.

Figure 6. EM central banks should continue cutting rates, having paused in H2 2024



Source: Macrobond, Mercer. Data as of September 18, 2024.

We expect the BoJ to continue hiking interest rates at a moderate pace in 2025. Inflation should remain above the BoJ's 2% target as rates are still very low. We expect the BoJ to at least reach the lower bound of its neutral rate estimate in 2025, which is 1%.[7] This would imply a rate hike roughly every six months. However, if we were to witness more persistence in the inflation data, the BoJ could move more aggressively, taking rates well above 1%. Ultimately, in Japan, economic activity is strong and inflation is above target, suggesting notably higher interest rates are needed. This is in contrast to the rest of the developed world, where policy is too restrictive and where we expect cuts.

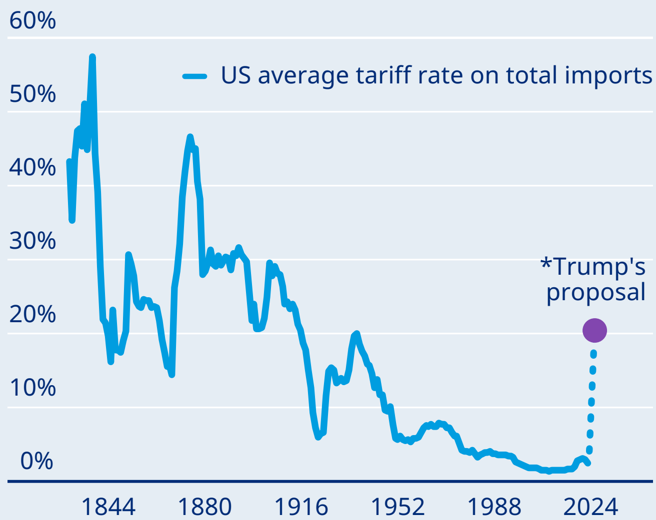
Risks

Following the election of President-elect Trump, risks to both the upside and downside for growth and inflation have increased significantly. A number of policies proposed are a departure from the current administration, such as increased fiscal spending and deregulation. The more extreme of President-elect Trump's policies are his policies surrounding tariffs. President-elect Trump is proposing upward of 60% tariffs on Chinese imports and potentially a broad 10% tariff on all imports from the rest of the world. It remains to be seen whether these tariffs would be implemented or whether the threat of them would be used to negotiate better trade deals for the United States. However, if they were to be implemented, the scale of these tariffs is much bigger than the tariffs implemented in 2018/2019 and would be the largest increase in tariffs in over 100 years.

When we look toward 2025, we believe one of the main risks is an underestimation of the lagged effects of monetary policy, which could lead to a recession in one or more economies. Growth has remained remarkably resilient in the face of one of the most aggressive rate-hiking cycles ever. In the US, there are factors that can explain the bluntness of the monetary policy transmission, such as the prevalence of long-term fixed-rate home mortgages and strong investment in a range of new technologies.

More optimistically, artificial intelligence (AI) and some other new technologies could lead to a pickup in productivity growth across much of the world. There are various estimates of the potential for AI, ranging from minimal to hugely significant. We believe AI is likely to deliver substantial productivity gains and could have a considerable impact on economic growth in coming years, representing an upside risk to growth for 2025 and beyond. AI also could present disinflationary risks

Figure 7. Average tariff rates could increase considerably



Source: USITC, Barclays Research, Mercer. As of November 2024. Note: Assuming President-elect Trump's new tariff proposal of 60% on all Chinese imports and 10% on all imports from the RoW.

over the coming years as any future increased productivity and automation puts downward pressure on wages.

Our views on China are informed by the belief that policymakers will ultimately backstop growth and resolve deflation risks. However, the timing of this remains uncertain. The past few years have shown that China's policymaking is not always transparent and thus does not necessarily follow conventional economic policy playbooks. China's policymakers appear to be prioritizing strategic and long-term political and economic objectives in sacrifice of short-term economic growth.

Numerous armed conflicts around the world also create risks to economies and markets. It remains to be seen how geopolitical events will unfold following the change in president in the US; it is possible that President-elect Trump may push for fast resolutions, therefore reducing geopolitical risk globally. However, broadly speaking, geopolitical events are notoriously hard to predict, but we believe risks will remain contained for now. While financial markets can be volatile as these events happen, the effects tend to unwind over time.[8]

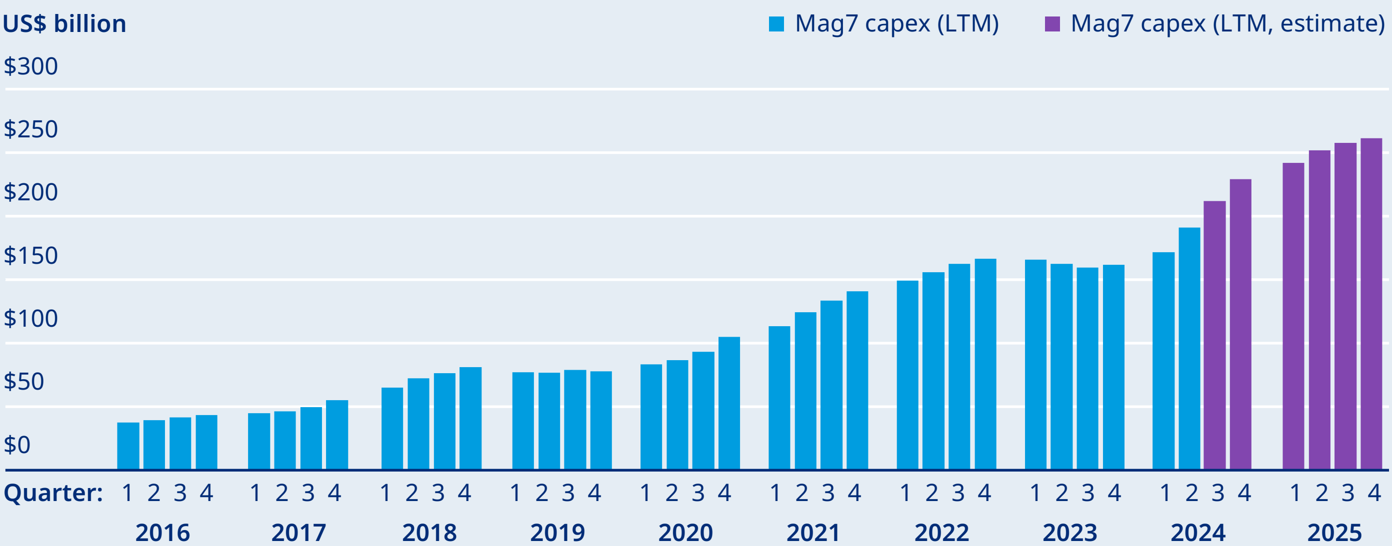
Asset allocation

Equities

The macroeconomic backdrop for 2025 is mixed for equity prices. Despite slightly softer economic growth, it seems likely companies will be able to increase profit growth at a strong level in both the developed and emerging markets. Lower corporate taxes in the US could lead to upward earnings revisions. We see upside risks from AI that could boost corporate profitability by increasing productivity. Lower inflation and interest rates are also supportive. However, it is not all positive for equities. Stretched valuations temper our optimism, plus the prospect of tariffs will likely reduce the competitiveness of US businesses and could trigger a broader and more damaging trade war. We do find opportunities, however, within the broader equity universe:

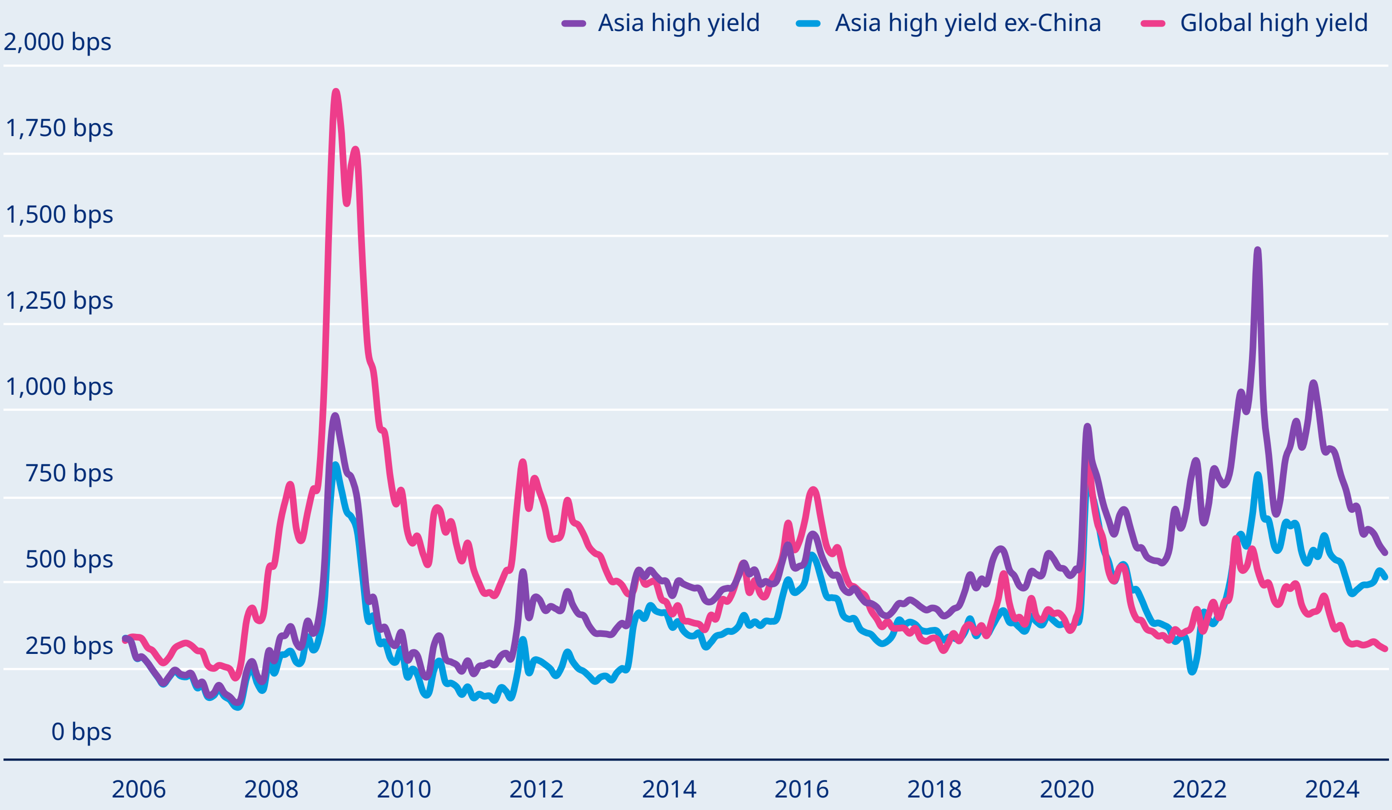
- Japanese equities benefit from a structural pickup in nominal growth, including accelerating capital expenditure.
- REITs fundamentals are solid, and there is a misplaced narrative on the composition of the indices that leaves the asset class largely unloved.

Figure 8. AI capex spend is set to accelerate



Source: JP Morgan Equity Macro Research, Bloomberg, Factset, I/B/E/S, Compustat, Mercer.
Data as of October 8, 2024. LTM = last twelve months. Mag 7 = magnificent seven.

Figure 9. High-yield spreads in Asia remain attractive relative to global



Source: JP Morgan, Refinitiv, Mercer. Data as of September 30, 2024.

Although emerging market equities offer attractive valuations and macroeconomic backdrop, if policy announcements continue to ramp up, we are cognizant of confidence risks surrounding tariffs which could see sentiment drop significantly and thus equity prices. Which leads us to be neutral until further clarity on trade policy is gained.

Growth fixed income

Moderate defaults support global high yield, while all-in yield investors may move further out on the risk spectrum and invest in high-yield assets.

Despite this, global high-yield spreads are at tight levels and do not provide a compelling opportunity. However, we continue to find two high-yielding assets attractive, FMD[9] and AHY.

With both, attractive fundamentals are met with equally attractive valuations and lower defaults than seen in traditional global high yield.

FMD defaults were very low in 2023 and 2024, and we expect that to continue in 2025, with dollar debt markets opening at last.

More than 70% of the AHY asset class is debt issued by non-Chinese issuers where spreads are high and defaults low. In China, over 20%+ of the asset class is non-property and defaults and spreads are low.

Chinese property debt is less than 10% of the universe, and, here, spreads and defaults are higher. We expect defaults to fall in 2025, although as previously noted, much depends on supportive government policy.

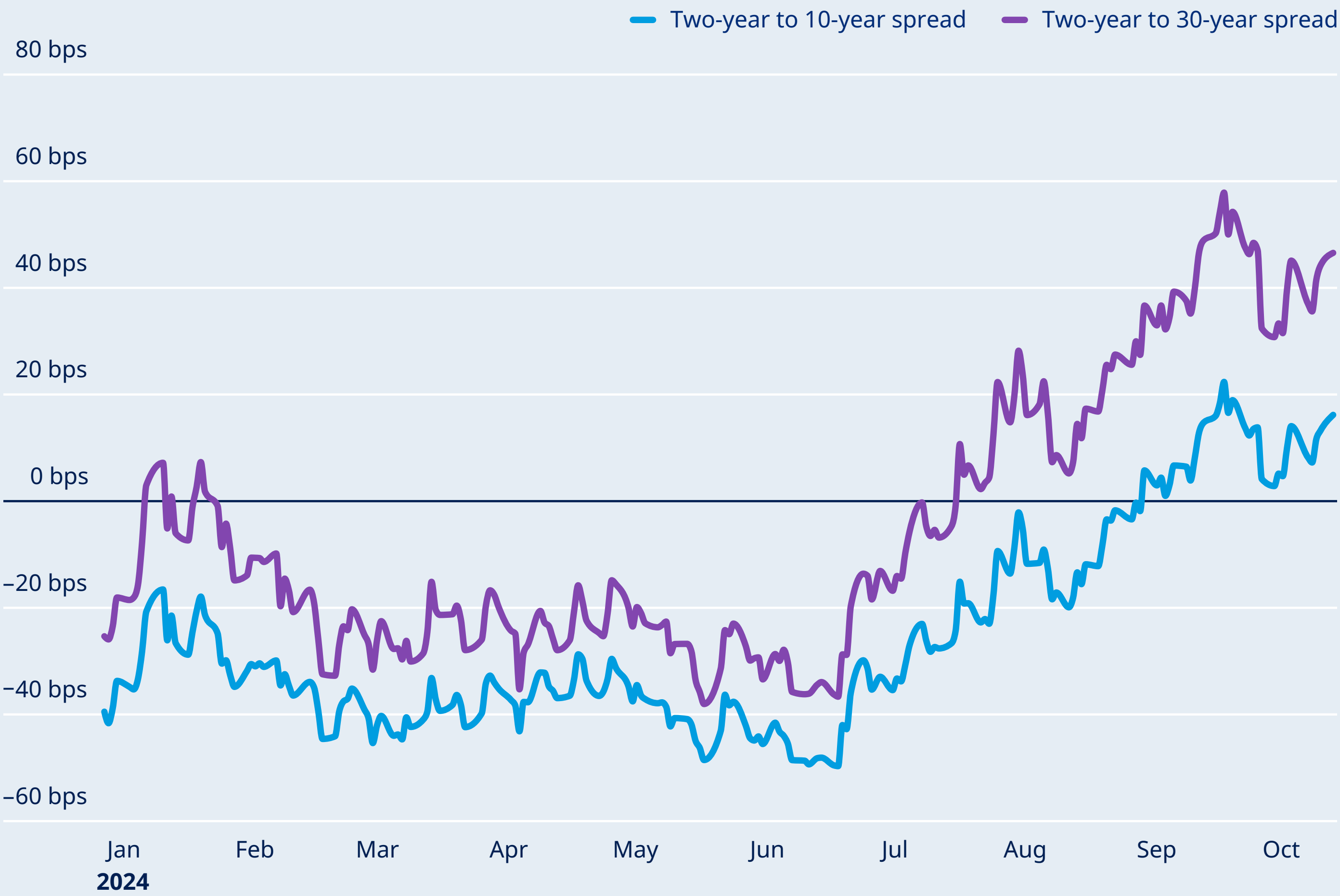
In portfolios that have a broad opportunity set, we are underweight global high yield as an offset to pro-risk positions in FMD, AHY and equities.

Defensive fixed income

Nominal government bond markets are pricing in most central banks, ex Japan, to cutting interest rates over the next year. Our base case remains that central banks will gradually cut interest rates and by slightly less than what is currently priced in, which could put a little upward pressure on yields.

We think the so-called "neutral rate" in much of the developed world is much higher than those seen in the 2010s and only a bit below the levels seen in the 2000s. Although we do not expect yields to move substantially higher, a small duration underweight seems appropriate, especially given other positions. We are modestly underweight Global Sovereign Bonds, partly to offset the small duration exposure from other long fixed income positions. Real yields may move a little higher in line with higher nominal yields, with the exception of the UK, where we expect the yield differential between government- and index-linked gilts to narrow. Similar to our view on global high-yield bonds, global investment-grade credit spreads are also tight and close to all-time highs. Although downgrades may remain low, there is little scope for spreads to narrow meaningfully.

Figure 10. Yield curves have steepened



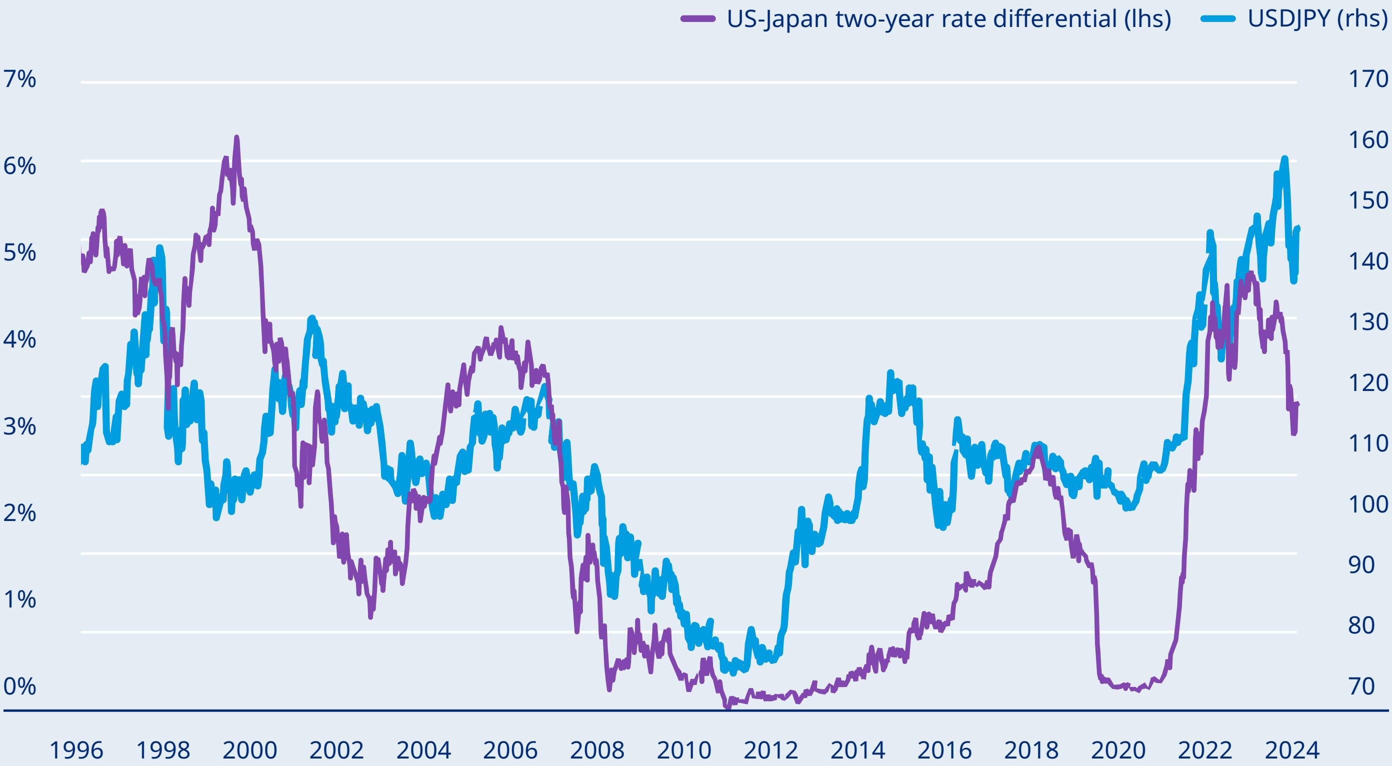
Source: Bloomberg, Mercer. Data as of November 6, 2024. A positive spread implies an upward-sloping yield curve such that longer-dated bonds on the yield curve offer higher yields than shorter-dated bonds.

FX

We retain a high conviction overweight position on the Japanese yen. As highlighted in our 2024 Economic Outlook, the currency is at its cheapest levels on a real basis since the 1970s. Despite a large intra-year movement across 2024, this remains as true now as it was then. The yen is experiencing increasing macroeconomic tailwinds, yet it is unloved and extremely cheap, creating asymmetric upside potential. As the BoJ continues to tighten monetary policy and investors betting on yen depreciation continue to unwind positions, the yen should further appreciate. To fund our yen view, we are underweight the Swiss franc, the New Zealand dollar and the euro. We have also recently sold the offshore Chinese renminbi (RMB) versus the US dollar due to the possibility of substantial RMB weakness if US tariffs are threatened and applied.

We also continue to slightly favor EM currencies implicitly via our FMD position. Looking ahead, higher real yields and attractive valuations and larger rate cuts by DM central banks should increase the attractiveness of EM currencies versus non-US-dollar currencies.

Figure 11. Japanese yen remains cheaply valued



Source: Refinitiv, Mercer. Data as of November 6, 2024.

Appendix

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Endnotes

1 Based on Goy-Iwasaki (2023) model, Bank of Japan's estimate.
2 https://insightcommunity.mercer.com/research/672bca6464351153be43f4b6/Mercer_US_Election_Results_The_Day_After.
3 Core CPI = National CPI ex-fresh food.
4 The wheel of inflation refers to the cyclical process in which rising costs, higher prices and increased wage demands reinforce each other, perpetuating inflationary pressures in an economy.
5 Three percent base wage growth supports 2% inflation target according to BoJ.
6 The neutral rate of interest, or r*, is where monetary policy is neither accommodative nor restrictive. Neutral rates of interest are inherently difficult to estimate as they are completely unobservable.
7 Based on Goy-Iwasaki (2023) model, Bank of Japan's estimate.
8 https://insightcommunity.mercer.com/api/v1/uploads/c3e7d15876f0440cae2b6754c77742ca.pdf?public=false.
9 FMD is a higher-yielding sub-sector of emerging market debt (EMD). See Mercer paper for further background: https://insightcommunity.mercer.com/api/v1/uploads/Frontier_Market_Debt_6a7ce28f4c.pdf.